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C O N F I D E N T I A L SECTION 01 OF 03 TEGUCIGALPA 000242

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STATE FOR WHA/CEN, WHA/EPSC AND EEB/OMA
TREASURY FOR IMF EXECUTIVE DIRECTOR
MADRID FOR HUGO LLORENS
BRASILIA FOR SIMON HENSHAW

E.O. 12958: DECL: 01/29/2018
TAGS: EFIN EAID IMF HO
SUBJECT: GOH NEAR AGREEMENT WITH IMF ON STANDBY

REF: A. TEGUCIGALPA 138
¶B. TEGUCIGALPA 84

Classified By: Ambassador Charles A. Ford, E.O. 12958 Reason 1.4(d)

¶1. (C) Summary: Sources here expect the IMF Board next month to approve a Precautionary Standby Agreement with Honduras. Under this agreement, which represents a lower level of ambition than what was being discussed in January (ref B), Honduras is to stabilize its international reserves and devalue its exchange rate by means of a crawling peg. It would not endorse limits on luxury imports, which the Central Bank was recently pushing. Honduras will receive no balance of payments support from the Fund under this agreement, but the GOH will likely try to use it to pry loose budget support funds from other donors. Unless the Board overrules IMF Staff, the agreement would also implicitly bless a scheme by the Central Bank to finance the debt of the state electric utility by manipulating reserve requirements in a way that foreign bank representatives here claim is designed to limit their market share. End Summary.

Fund and GOH Close to a Deal

¶2. (C) IMF ResRep Mario Garza told EconCouns March 3 that the Fund was close to closing a deal with the GOH on a watered-down Precautionary Standby Agreement that he expected to be presented to the IMF Board for approval in April. He said the GOH had accepted the IMF's crawling peg proposal for the exchange rate and had already allowed some little-noticed microadjustments to the rate as a precondition. Also as a precondition, the GOH is to assure that Central Bank foreign reserves at the end of March are no lower than the year-end 2007 level, which would require them to increase slightly from where they stand now. There will be monthly targets thereafter under the agreement. The GOH must also get an acceptable budget approved by Congress and commit to a further 11 percent increase in electricity tariffs.

¶3. (U) Press here are reporting that the agreement will be approved April 9. However, at a March 12 meeting between G-16 donors and members of the National Congress, Garza said the budget would need to be approved at least two weeks before the IMF Board could vote on the agreement. Given that the Congress will be in recess next week for Holy Week, Congress Vice President Lizzy Flores said that timetable would be difficult if not impossible to meet, since the GOH has not yet presented the budget to the Congress. President

of Congress Roberto Micheletti said March 13 that the budget would not be approved until April 20, assuming the GOH submits it after the recess.

¶4. (C) Garza said the GOH had dropped the idea, being pushed last month by Central Bank President Edwin Araque, of limiting luxury imports, as the Fund had refused to support it. But the fund has reluctantly acquiesced to Araque's scheme to manipulate reserve requirements, conditional on the composition of banks' loan portfolios (see below) so as to find a market for bonds to bail out the National Electric Company (ENEE). GE and Citibank reps have complained to us that the scheme was deliberately designed to limit market share of foreign-owned banks.

¶5. (C) Garza told us that under this minimalist agreement, Honduras will receive no financial support from the Fund. But the GOH wants the agreement as a "seal of approval" for its fiscal policy, and probably as an instrument for persuading other donors, such as the World Bank, Germany and Spain, to release budget support funds. IMF staff, and local World Bank officials, are supporting the agreement because it allows the IFIs to continue to monitor GOH fiscal performance.

U.S. Banks Concerned about New Reserve Scheme

¶6. (U) Araque announced publicly the week of February 18 the Honduran Central Bank (BCH) would increase the "obligatory investment" requirement (the share of deposits that must be backed by government bonds) for lempira deposits from 4 percent to 9 percent, phased in over three months beginning in March. The clear and stated objective is to create a

captive market for the 4 billion lempiras (USD 212 million) of bonds the GOH needs to place to pay off the accumulated debt of ENEE to private power producers (whose support the GOH needs for its plan to purchase heavy fuel oil from Venezuela through Petrocaribe). BCH also probably hopes to lower the cost of government borrowing overall.

¶7. (SBU) In fact, since Araque's announcement, the GOH was able to place 679,000 lempiras of ENEE bonds at a coupon rates as low as 9.5 percent, which is not enough even to cover inflation. Previously, banks had been demanding rates of 14 percent or more. (Annualized inflation the last four months as been 11.4 percent)

¶8. (U) To compensate the banks and to avoid inducing an economic slowdown, the increased investment requirement is to be accompanied by a simultaneous phased reduction of the cash reserve requirement for lempira deposits from 12 percent to 7 percent, and of the obligatory investment requirement on deposits in foreign currency (primarily dollars) from 24 percent to 14 percent. However, to benefit from the lower cash reserve requirement, banks must have at least 80 percent of their loan portfolios in "productive investments," defined as something other than consumer or commercial credit.

¶9. (SBU) The innocent explanation for this direct portfolio mandate is that the BCH wanted to assure that the increased liquidity resulting from the lowered cash reserve would not further fuel inflation, currently running at double digits. (Comment: Treasury OTA analyst does not expect the effect of the changes on liquidity to in fact be neutral, since the increased obligatory investment will finance bonds that will be used to pay off debt to private power producers, who will then deposit it back into the banks. End Comment) However, representatives of U.S.-invested banks strongly suspect that the large Honduran banks intervened with the BCH to manipulate the rules in such a way as to work to their advantage -- and to the disadvantage of foreign banks. The local manager for BAC (majority owned by GE) is also worried that the changes will put upward pressure on credit card

rates -- already 30-60 percent -- reviving GOH talk of capping them.

¶10. (U) A survey by the Honduran Banking Association (AHIBA) revealed that of its 18 member banks, only one met the criteria for the reduced reserve requirement. However, six, all of them local, have portfolios comprising less than 30 percent consumer and commercial credit. Those banks have told AHIBA they could reconfigure (or relabel) their portfolios to qualify. Meanwhile, seven banks -- almost all foreign -- hold more than 50 percent consumer and commercial loans.

¶11. (SBU) Maria Solano, executive director of AHIBA, told econoff AHIBA is strongly against the proposed changes, which she sees as an unnecessary attempt to control the markets and a serious disincentive for transparency among bankers (since banks will have an incentive to misrepresent the purpose of their loans so as to qualify for the lower reserve requirement). AHIBA sent a letter to Araque February 20 spelling out its concerns about the new regulations, including that they would lead to higher interest rates, that the portfolio mandate cannot be enforced (the National Bank and Insurance Commission says it does not have the capacity to monitor the composition of bank loan portfolios) and that Honduras's shadow sovereign bond rating could suffer.

The Fund's Attitude

¶12. (C) Garza said the IMF was in principle opposed to direct controls over bank lending policies of the sort Araque is proposing. Other critics have pointed out publicly that these sorts of controls were tried unsuccessfully in Honduras in the 1980s. However, Garza said IMF staff were not willing to make this issue a deal-breaker for the Precautionary Standby Agreement. Also, he said, the staff had some sympathy for the GOH predicament of having to place 4 billion lempiras of bonds in a financial market where a small number of players can easily collude.

¶13. (C) The Staff report will note reservations about the scheme and will likely insist that the policy be reviewed in

May. Staff would also prefer the measures to have a time limit. Garza noted that the Board could insist on stricter limits on the measures when it votes on the agreement next month.

Comment

¶14. (C) The draft Precautionary Standby Agreement, as we understand it, is a minimalist package that President Zelaya undoubtedly hopes to use domestically to confer legitimacy on his fiscal policies and internationally to try to extract more direct budget support from donors. We see some benefit to the agreement in that it will give the IMF continued leverage -- however small -- over GOH fiscal and monetary policies. But other donors should not be fooled into increasing their support based on this agreement. For one thing, we expect the revenue projections and the investment plan in the budget the GOH will submit to assume that the GOH will receive USD 350 million over the next two years from the Petrocaribe deal with Venezuela that the Congress approved March 13. We and other donor reps here consider it extremely unlikely that Petrocaribe will yield that much disposable cash to the GOH. Thus, both the fiscal deficit and public investment will likely miss their targets. Also, we recommend that the U.S. Executive Director voice strong reservations about the BCH reserve requirements and portfolio mandate. End Comment.
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